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Texas House of Representatives
Committee on Pensions & Investments

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January 17, 1996

Honorable Dan Morales
Attorney General of Texas
Opinion Committee Division
P.O. Box 12458, Capitol Station
Austin, Texas 78711

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Opinion Committee

RE: May a trust governed by the *Texas Trust Code* properly distribute short term capital gains as income to the Trust beneficiaries?

Dear General Morales:

I. Introduction to Pooled Income Funds.

Charitable pooled income funds are given favorable tax treatment by the federal government because of their benefits to charities. Internal Revenue Code ("IRC") § 642(c)(5) governs the requirements for a trust to qualify as a pooled income fund. They are especially convenient for use by donors of relatively small sums, who can gain the advantage of professional management at low costs by pooling contributions with other, like contributors. Under the terms of the trust agreement which establishes the pooled income fund, a donor pledges assets to charity, but the charity does not receive the income until the donor's death. During the donor's lifetime, the donor retains an income interest in the assets. See Treas. Reg. § 1.642(c)-5(b). The funds from each donor are pooled and invested with other like donations. Often smaller pooled income funds invest their assets in mutual funds rather than bear the costs associated with setting up a separate portfolio of stocks and bonds. The manager of the fund is more easily and cheaply able to invest the larger sum of money. Such a "pooled" arrangement makes giving assets to charity more affordable, since a separate trust is not needed for each donor. The donor receives the income for the period designated in the donative transfer and, upon the donor's death (or any other terminating event established by the donor), the fund manager distributes the assets to charity, as directed by the donor.

Sherri Walker, Chief Clerk
P.O. Box 2910 • Austin 78768-2910
(512) 463-2054

II. The Income Distribution Requirement.

The attraction of a charitable pooled income fund is determined, in large part, by its ability to deliver a return to the donor, as income beneficiary. The fund is required to return income to the income beneficiaries. With respect to the mutual funds in which the pooled income fund invests, mutual fund distributions are paid from two sources for income tax purposes:

- (1) Investment company taxable income (net investment income plus net short-term capital gains) - designated as "dividend" distributions; and
- (2) Long term capital gains (net long-term capital gains minus net short-term capital losses) designated as "long-term capital gain" distributions.

For securities law purposes, a mutual fund must separately designate distributions from capital gains as long-term or short-term. Nevertheless, a short-term capital gain distribution for securities law purposes is treated as a dividend for tax purposes.

Texas has yet to determine if a charitable pooled income fund can distribute short term capital gains or short term capital gain mutual fund dividends ("ST Dividends") to the income beneficiaries. Allowing charitable income funds to make such distributions would greatly enhance their ability to deliver a high return to the income beneficiary. If the funds are not allowed to make such returns, it will have a negative impact on their existence in Texas, since the funds easily can choose to operate under the laws of another state which allows distribution of short term capital gains as income.

III. Short Term Capital Gains Should be Distributable to Income Beneficiaries.

Pooled income funds are governed by both state and federal laws. For a pooled income fund to take advantage of the opportunity allowed by federal tax standards, it must be consistent with Rev. Proc. 88-53, follow the terms of the trust agreement, and be valid under local law. Revenue Procedure 88-53 provides that:

The operation of the fund shall be governed by the laws of the State of _____. However, the trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualifications of the fund under Section 642(c)(5) of the Code and corresponding regulations.

IRC § 642(c)(5) sets out the procedure for donating and accepting property into a pooled income fund. The section reiterates that the trust must abide by local laws. *See also*, Private Letter Ruling 9402020 (income of pooled income fund is determined under the terms of the governing instrument and local law).

The IRS has previously determined that a pooled income fund that distributes net short term capital gains to the income beneficiaries continues to qualify as a pooled income fund under IRC § 642(c)(5). Private Letter Ruling 8404039. Although Private Letter Rulings are not binding on the IRS, they usually are good indicators of the IRS's position. Thus, Private Letter Ruling 8404039 indicates that if the local laws of Texas allow distribution of short term capital gains as income, the IRS will find that funds distributing short term capital gains as income continue to qualify for the favorable tax treatment given to pooled income funds under IRC § 642(c)(5).

For the question at issue, the key local laws are the sections of the *Texas Trust Code* that determine income and principal. The Texas Principal and Income Act provides in § 113.104(c)(3) that a corporate distribution by a regulated investment company (*i.e.*, mutual fund) is principal if it is:

any distribution except from ordinary income by a regulated investment company or by a trust qualifying and electing to be taxed under federal laws as a real estate investment trust, including a distribution from capital gains, depreciation, or depletion, regardless of whether the distribution is cash, an option to take new stock or cash or an option to purchase additional shares.

Under § 113.104(c)(3) are short term capital gains or ST Dividends classified as "principal"? If this section does not include short term capital gains or ST Dividends as principal, then §113.104 classifies them as "income". It is unclear from the statutes whether short term capital gains or ST Dividends should be classified as income or principal.

The *Texas Trust Code* provides that in the first instance, income is to be determined by the instrument establishing the trust. Only when the instrument is silent will the Texas Principal and Income Act govern the character of distributions. Nevertheless, under federal law, if a trust is seen as fundamentally departing from local laws, then it will not be afforded its favorable federal tax status. Treas. Reg. § 1.643(b)-1. Therefore it is very important that the trusts only distribute that which the State of Texas recognizes as income, without taking into account special provisions in the trust instrument.

The relevant provision of the Texas Trust Code, quoted above, has never been interpreted in Texas regarding the proper allocation of short term capital gains or ST Dividends. The Texas courts, however, have recognized, in a decision that pre-dates the adoption of § 113.104, that allocation of capital gain to income beneficiaries can be proper. *Thorman v. Carr*, 408 S.W.2d 259 (Tex.Civ.App.--San Antonio, 1966, writ ref. n.r.e.).

Moreover, courts in several other states have held that capital gains distributed from mutual funds to trusts may be allocated to the income beneficiaries of the trust. See, *e.g.*, *Manufacturers Hanover Trust Co. v. Bartram*, 158 Conn. 48, 255 A.2d 828 (Conn. 1969); *Coates v. Coates*, 304 S.W.2d 874 (Mo. 1957); *Estate of Pernas v. Roman Catholic Orphan Asylum*, 268 Cal. App. 2d 275, 74 Cal. Rptr. 8 (1968). The rationale behind these cases was expressed well

in *re Byrne's Estate*, 192 Misc. 451, 81 N.Y.S.2d 23 (NY Sur. 1948), in which the court stated: "The buying and selling of securities is the operating procedure of investment companies and the profits derived from such activities when distributed to stockholders in the form of dividends are income and not principal." Thus, although for private Trustees, allocating long term capital gains as well as short term capital gains to principal may be correct, for mutual fund investments made by corporate Trustees, short term capital gains should be allocated to income since the yield is affected.

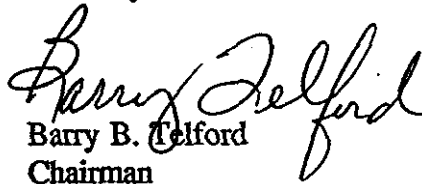
Whether short term capital gains or ST Dividends may be distributed to the income beneficiaries of a pooled income fund is of major concern to the managers and beneficiaries of trusts. Permitting short term capital gains or ST Dividends to be distributed as income will have a positive impact on the effective yield of such trusts. The managers of these funds would view Texas as a more favorable state in which to manage these large sums of money. This issue also affects charities and the Internal Revenue Service. All of the parties would be better served by a clarification of Texas law.

Your opinion is requested on the following questions:

1. Under Section 113 of the Texas Trust Code, are short term capital gains classified as income or principal?
2. Under Section 113 of the Texas Trust Code, are the short term capital gain component of mutual fund dividends classified as income or principal?
3. Is the distribution of short term capital gains as income consistent with Texas law?
4. Is the distribution of the short term capital gain component of mutual fund dividends income consistent with Texas law?

Thank you for your attention and assistance in resolving these questions. As soon as this request has been assigned, I would appreciate your contacting Sherri Walker at 463-2054 in my committee office.

Sincerely,


Barry B. Telford
Chairman